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SUBJECT: RESPONSE: IMPACT OF RISING FOOD/COMMODITY PRICES - EGYPT

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SUMMARY

11. (SBU) Rising global food prices are hitting Egypt's poor hard and are the major contributor to stubbornly high inflation (14.4% y-o-y in March). Past episodes of rising food prices (e.g., 2003-05) pushed Egypt's poverty rate up, and some fear this is happening again now. Almost every international media report on the global food crisis mentions Egypt's bread lines. The bread lines, however, are less an indication of scarcity than of corrupt leakages in a bread subsidy system that does not really target the poor. The economic reformers in the GOE responsible for Egypt's 7% growth rate recognize that market-distorting subsidies are ineffective in combating poverty. But the GOE can not change the subsidy system at a time of high global food prices. Fear of change is too powerful among the population, and reform of the subsidy system at such a volatile moment could lead to more of the social unrest Egypt has seen in the past few months. End summary.

DEMAND

12. (U) With a growing population and 7% economic growth, food demand has been and is expected to remain strong. Wheat, corn, sugar, beans, rice and vegetable oil are the most important staple commodities consumed in Egypt. Egypt is a net importer of all these commodities except for rice, which Egypt traditionally exports. The import/local production ratio for wheat and corn are about 50/50, sugar is about 40/60 and beans are about 30/70. Egypt is almost completely dependent on imports of cooking oil, importing palm and sunflower oil, as well as corn and soybeans, which are processed locally to make oil and also used as animal feed.

13. (SBU) As a net food importer, Egypt's domestic prices have risen in tandem with international commodity prices. Egypt's Central Agency for Public Mobilization and Statistics (CAPMAS) reports that the price of the average consumer food/beverage basket rose 24% from March 2007 to March 2008, 27% in rural areas. Individual items

exhibited even greater increases, with vegetable oil and bread up 45% and 48%, respectively. Though CAPMAS's statistical methods have improved recently, data may still substantially underestimate actual price increases for certain staple goods. Informal surveys by FAS, for example, indicate that consumer-ready retail flour and rice prices more than doubled in the past year and retail vegetable oil prices have almost tripled.

¶4. (SBU) When wheat/flour prices began to accelerate in early 2007, consumers began switching to rice. But as rice prices then skyrocketed as well, the rice-wheat flour substitution trend abated.

As global vegetable oil prices rose, imports of palm oil were down, but this was mainly due to a decision by Malaysia - Egypt's traditional supplier - to meet commitments to other buyers first. Declining palm oil imports were offset by increased soybean and corn imports. Flour/bread is the foundation of the Egyptian diet, and total demand remains firm. With higher wheat prices, however, demand for price-controlled or "subsidized" bread has increased as market prices of unsubsidized bread have risen. Low income consumers, who were once able to afford occasional purchases of unsubsidized bread, now increasingly opt to buy lower quality subsidized bread. Anecdotal evidence indicates that leakages of subsidized bread for use as animal feed also increased as market prices of normal feed rose.

SUPPLY

¶5. (U) While it is premature to forecast with any specificity, reports suggest that Egypt's wheat farmers are increasing area devoted to wheat. The General Authority for Supply of Commodities (GASC) is the central authority for domestic procurement and importation of wheat. To attempt to reward local producers for the higher international prices, the guaranteed price GASC pays farmers was increased to \$466/ton for the current harvest season (which will begin in May), more than double the previous crop year, but still hundreds of dollars below international prices. Several large land reclamation projects are being brought into production, but Egypt lacks the productive land and water resources necessary to expand domestic production in any meaningful way. Higher fuel and fertilizer costs are also taking a toll on Egypt's ability to provide an adequate supply response. The overriding constraint on increased production, however, continues to be lack of sufficient land and water, a problem that has plagued Egypt since ancient times.

¶6. (SBU) GASC's stated policy is to maintain a six-month supply of wheat and, even as prices have risen dramatically, GASC and private importers have been able to acquire adequate supplies on the international market to meet this goal. Recently, however, GASC has held on average only about 2 months of stocks, including "pipeline" stocks, or product in-transit. With the sharp increase in prices, wheat is simply too expensive for GASC to maintain a large inventory.

¶7. (U) Egypt usually produces a surplus of rice, exporting about 1 million tons per year. But when local rice prices increased from about \$450/ton to \$750/ton in April 2008, Egypt banned rice exports to ensure that sufficient supplies remain in the domestic market.

ECONOMIC IMPACT

¶8. (SBU) The increase in wheat prices exposed and exacerbated inefficiencies and corruption in Egypt's subsidized flour/bread supply and distribution system. Every consumer in Egypt is eligible to buy subsidized bread at about \$.01 per flat, round "loaf." As world prices rose, the difference between subsidized flour and non-subsidized flour prices increased commensurately, leading to an increase in numbers of millers and bakers willing to illegally sell their quota of subsidized flour on the black market. This practice, combined with greater demand from consumers opting for subsidized bread rather than higher quality, more expensive bread, led to long lines at public bakeries. Anxiety over long bread lines resulted in media reports of bread "shortages." However, the lines were less the result of short supplies than of diversion of subsidized flour

to the black market and precautionary purchases ("hoarding").

¶9. (U) Food prices are the driving force behind inflation in Egypt, although rising prices for construction materials are also a significant factor. High food prices have been manageable within Egypt's balance of payments, as a capital account surplus from strong investment inflows offsets the widening trade deficit. However, the increased cost of food subsidies (along with energy subsidies) will make it impossible for the GOE to meet its goal of reducing the deficit from 7% currently to 4% by 2011. The FY 2007/08 budget for food subsidies stands at LE 20 billion (\$3.7 billion), a 33% increase over FY 2006/07. The GOE also recently announced plan to add some 15 million people to the ration-card system in place since the 1950s. The currently strong economic growth, which reached 7% this fiscal year, is expected to continue.

¶10. (U) Inflation disproportionately affects the poor, and food prices disproportionately affect the poorest. World Bank (WB) analysis of the 2005 Household Income and Expenditure Survey (HIES), the best information available to date, estimates that some 3.8% of Egypt's population was so poor in 2005 (spending under \$1/day) that their entire income was not enough for an adequate diet. Another 15.8% of the population was poor enough that scrimping on food for other needs probably left them with inadequate diets, making a total of 19.6% of the population that was hungry as of 2005. As noted above, the GOE's subsidized bread distribution does not target this group: subsidized bread is available to everyone and the very poor are often not reached. According to the WB, Egypt's poor spend approximately 45% of their income on food.

¶11. (U) The WB blames a previous round of food price increases after 2003 (following the devaluation of the Egyptian Pound against the U.S. Dollar), along with the failure of the bread distribution system to target the poor, for increasing the proportion of the population that is very poor from 2.9% in 2000 to 3.8% in 2005. The "scrimping" group also grew from 13.8% of the population in 2000 to 15.8% in 2005, for a total increase of 2.9% in the share of the population that was hungry (16.7% to 19.6%). A similar increase is presumably occurring now, although we must await a fresh HIES survey to measure accurately. The GOE plans to accelerate HIES surveys from once every five years to one every second year.

¶12. (U) The impact of higher food prices reaches higher income levels as well, but economic growth has mitigated the impact for those with more income. The 2005 HIES data found a reduction in the "near poor" (the non-poor with incomes below about \$2/day) from 25.9% of the population in 2000 to 21.0% in 2005. The increase in economic well-being for middle income earners stems from better job opportunities, which outweighed the impact of higher food prices after 2003. As economic growth has accelerated since 2005, this affect is likely to have strengthened as well. Fruit and vegetable farmers are benefiting somewhat from high prices, as they can now sell domestically at international prices. Grain farmers, however, depend partly on GASC's purchase prices. Although higher now, GASC's prices are still lower than international prices.

POLITICAL IMPACT

¶13. (SBU) Sporadic violence has broken out in bread lines at public bakeries, killing eleven people over the past few months. Public frustration over the bread crisis and spiraling food prices have become intermingled with labor unrest, mainly dissatisfaction with low wages and lack of action by government-controlled labor unions. Participants in recent demonstrations in the textile factory town of Mahalla for higher wages were confronted by security forces and turned violent. Opposition parties and also many members of the NDP in parliament have called for greater government action to control food prices. In his Labor Day speech, President Mubarak announced a 30% increase in base public sector wages, and had previously ordered the Cabinet to find funds in the budget to increase subsidy expenditures.

GOVERNMENT POLICY RESPONSE

¶14. (U) In addition to banning rice exports, the GOE lowered duties on vegetable oil and dairy products. Duties on bulk commodities (corn, soybeans, wheat) were already zero. Egypt and Syria usually sign an annual rice/wheat barter deal. However, with Egypt's ban on rice exports and concerns that Syria's wheat crop may be well below average this year, this traditional barter deal may not go through in 2008/09. The Central Bank raised interest rates several times over the last few months in an attempt to control inflation, but this has not been very successful. Substantial liquidity from Gulf oil money prevents interest rate increases from dampening inflation.

¶15. (U) To control corruption, the GOE has ordered the separation of bread production from distribution. Public bakeries receiving a quota of subsidized flour are now required to deliver a quota of subsidized bread at distinct distribution centers. The GOE also directed police and military bakeries to produce and distribute subsidized bread for the general public. Reports of bread lines have subsided somewhat since implementation of these measures.

¶16. (U) In addition to subsidized bread, which is available to anyone, the GOE provides ration cards for about 11.1 million people and plans to add another 15 million soon, as noted above, bringing the total to nearly one-third of the population. The program provides sugar, edible oil, rice, beans, lentils, and tea to ration card holders. Like the bread subsidy system, however, the ration card system does not adequately target the poor and is riddled with corruption. By having goods sold at both a "market price" and a "subsidized price" in the same store, the temptation for the store owner to sell the subsidized goods at the market price is simply too great. The GOE is attempting to reform the ration card system by introducing food subsidy "smart cards," though these are not yet widely used, and we have no evidence yet of the cards' success at addressing corruption. The GOE eventually plans to move to a cash subsidy system to replace all in-kind programs, but this plan is not politically feasible for now.

¶17. (U) Prior to the steep increase in commodity prices, the private sector was assuming an increasing role in imports and the GOE was considering elimination of GASC and privatization of all wheat procurement and distribution. The rise in food prices, however, led to calls for the GOE to be more active in managing inflation, which in turn has stalled efforts to privatize wheat imports. With public calls for the GOE to do more, GASC's role in wheat imports is again dominant.

POLICY PROPOSALS

¶18. (SBU) We support the GOE's plans to move gradually to a cash subsidy program that targets the poor and reduces waste and corruption. We recognize, however, that Egypt's culture is powerfully resistant to change, so maintaining a broad food safety net is unavoidable for the time being. If the deeply inequitable and extremely expensive fuel subsidies continue to be reduced (per the recent increase in fuel prices for heavy industrial users), Egypt may be able to bear the price of a limited and better targeted food subsidy system. However, the GOE should not derail market forces in the bulk of the commercial markets for grains and other food commodities. Cost-reducing investments, including rationalization in use of land and water resources and improved irrigation methods, are also critical to increasing agricultural production in cost-effective manner.
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